DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUGUST 16, 2000

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

CC:
Attn: and

FROM: HEATHER MALOY
Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Deductibility of legal judgment against foreign subsidiaries

This Field Service Advice responds to your memorandum dated May 5, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Sub1 =
Sub2 =

Sub1/Sub2 =

Corp X =
Corp Y =

$a =

N =
M =

ISSUE:

Whether taxpayer is entitled to deduct the amount of $a transferred to Sub1 for the payment of a legal judgment in said amount against Sub1/Sub2 as an ordinary and necessary business expense under I.R.C. § 162 for the tax year.

CONCLUSION:

Taxpayer has failed to demonstrate the transfer of funds for the subsidiaries' legal judgment was directly related to the taxpayer's own business; therefore, taxpayer may not deduct the amount of the transferred funds as an ordinary and necessary business expense under section 162.

FACTS:

The facts as you have provided are as follows:

Taxpayer is in the business of developing

. In , taxpayer purchased all the shares of Sub1, a N corporation specializing in the and , and the shares of its subsidiaries, including Sub2, a M corporation.

Prior to the purchase of the shares, in , Corp X, an unrelated N manufacturer of , contracted with Corp Y, an unrelated M company, for the design and manufacture of a . Corp Y, in turn, subcontracted with Sub2 for the design and manufacture of a to be incorporated into the .

In , the first test on the revealed that the did not conform to Corp X's requirements. Corp Y requested Sub1/Sub2 improve the performance of the . Still unsatisfied with the performance of the , Corp X canceled its contract with Corp Y on

In , an expert determined that a significant cause for the failure was the improper functioning of the

.

On , Corp X sued Corp Y for damages for breach of contract. On , Corp Y sought damages from Sub1/Sub2. On , per an agreement signed by Corp Y and Sub1/Sub2, Corp Y withdrew its claims against Sub1/Sub2. A few days later, Corp Y declared bankruptcy. As a result, Corp X sought damages from Sub1/Sub2. On , based on the findings of the expert, the court rendered a judgment against Sub1/Sub2. The judgment was affirmed by an appellate court on .

In a letter to Sub1, dated , taxpayer confirmed its oral agreement to pay the legal judgment. In the letter, taxpayer stated that Sub2 had become insolvent in , and taxpayer had ceased Sub2's operations and terminated all employees. As the sole shareholder and "successor"[1] of Sub2, taxpayer promised to pay all liabilities arising from the Corp X/Corp Y litigation. Taxpayer stated that "because Sub2 was primarily responsible for the transaction that gave rise to the litigation, it would not be appropriate for Sub1 to shoulder the financial risk of an adverse outcome of the litigation." Taxpayer requested Sub1 pay Corp X the judgment directly and then send taxpayer an invoice for the amount of such payment.

Pursuant to taxpayer's request, Sub1 apparently paid the legal judgment and subsequently sent an invoice to taxpayer on . Via wire transfer, taxpayer paid the amount of the legal judgment to Sub1 on . Taxpayer, on the accrual method of accounting, deducted said amount in .[2]

In Taxpayer's Submission, dated , taxpayer, while generally recognizing a parent corporation may not deduct its subsidiary's expense, argued that in its case, taxpayer should be allowed to deduct the amount it transferred to Sub1 to pay the legal judgment because the transfer of funds to Sub1 was compelled by the need to protect taxpayer's business from harm. Taxpayer also

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[1] Exam advises taxpayer is using the term "successor" loosely. According to taxpayer's Form 10-K, dated , Sub2 was still in existence, although it was listed as "inactive."

[2] [redacted]
As you noted, an expense may not be deducted by two different parties. See Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850, 858 n.2 (1964), nonacq., 1965-2 C.B. 7. [redacted]

claimed the expenditure directly benefitted taxpayer's profit-oriented activities and was necessary for the preservation of taxpayer's existing business.

LAW AND ANALYSIS:

I.R.C. § 162(a) allows a deduction for ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business. Whether an expense is deductible under section 162 is ultimately a question of fact. See Commissioner v. Heininger, 320 U.S. 467 (1943). Generally, an expense is ordinary if it bears a reasonably proximate relationship to the operation of the taxpayer's business. See Deputy v. du Pont, 308 U.S. 488 (1940); Gill v. Commissioner, T.C. Memo. 1994-92, aff'd without published opinion, 76 F.3d 378 (6th Cir. 1996). An expense is necessary if it is helpful and appropriate in promoting and maintaining the taxpayer's business. See Carbine v. Commissioner, 83 T.C. 356 (1984), aff'd, 777 F.2d 662 (11th Cir. 1985); Gill v. Commissioner, supra.

Deductions are strictly a matter of legislative grace, and taxpayers must satisfy the specific requirements for any deduction claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

The Tax Court has considered the issue of whether one taxpayer is entitled to deduct, under section 162, reimbursements made to a wholly-owned subsidiary or other related party for business expenses incurred by the latter. The case law in this area is clear and from your FSA request and Taxpayer's Submission, it appears that both parties are well aware of the seminal cases. Accordingly, we will not repeat the lengthy case discussions, but only allude to the controlling facts and law in the cases as appropriate.

It is well-established that where a taxpayer undertakes to pay the obligations of another taxpayer, such payments are not deductible as ordinary and necessary expenses incurred in the payor's trade or business. See Interstate Transit Lines v. Commissioner, 319 U.S. 590; Deputy v. DuPont, 308 U.S. 488; Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964); Grauman v. Commissioner, 357 F.2d 504 (9th Cir. 1966).

With respect to a parent-subsidiary relationship, generally a parent corporation is not allowed to deduct expenses of its subsidiary. See Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965). Ordinarily, the separate corporate identities of parent and subsidiary preclude the parent from deducting expenses incurred or losses sustained by its subsidiary. The theory is that the payment by the parent to cover such expenses or losses is related to the business of the subsidiary and not to its own business. Fall River Gas Appliance

Co., 41 T.C. at 858, citing Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943).

However, reasonable expenditures made to “protect or to promote” a taxpayer’s business, and which do not result in the acquisition of a capital asset, are deductible as ordinary and necessary expenses of transacting a trade or business. See Crowder v. Commissioner, 19 T.C. 329 (1952), acq. 1953-1 C.B. 3; L. Heller & Son, Inc. v. Commissioner, 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2; Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948), acq. 1948-1 C.B. 1; Scruggs-Vandervoort-Barney, Inc. v. Commissioner, 7 T.C. 779 (1946), acq. 1946-2 C.B. 5. The crucial and controlling factor lies in determining whether the acts done and expenditures made were motivated by a purpose to protect or to promote the taxpayer’s business. See Alleghany Corporation v. Commissioner, 28 T.C. 298, 303 (1957), acq. 1957-2 C.B. 3; First National Bank of Skowhegan v. Commissioner, 35 B.T.A. 876 (1937), acq. 1937-1 C.B. 9. Of course, the burden is upon taxpayers to establish that the expense is proximately related to their business and is both ordinary and necessary. Issues of this type primarily raise questions of fact involving “the appreciation of particular situations, at times with border-line conclusions.” Welch v. Helvering, 290 U.S. 111, 116 (1933); Snow v. Commissioner, 31 T.C. 585, 591 (1958), acq. 1959-2 C.B. 5, and acq. 1959-2 C.B. 7; Fishing Tackle Products Company v. Commissioner, 27 T.C. 638, 643 (1957), acq. 1964-2 C.B. 5 and acq. 1964-2 C.B. 7.

Thus, where the parent is able to demonstrate that the payment of an expense incurred by the subsidiary is “directly related” to the parent’s own business, the payment qualifies as an ordinary and necessary business expense of the parent, deductible by the parent. See Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff’d, 943 F.2d 1318 (11th Cir. 1991).

In Coulter Electronics, Inc., the parent corporation was allowed to deduct reimbursements made to Coulter Electronics of Canada, Inc. (CEC), a wholly-owned Canadian subsidiary, for certain warranty expenses under section 162. The Tax Court found the warranty services performed by CEC would affect the parent’s sales, and, therefore, the reimbursements were “directly related” to the parent’s own business and deductible by the parent. Accord Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff’d, 349 F.2d 515 (1st Cir. 1965) (allowing parent to deduct payments for expenses incurred by its subsidiary where payments were directly related to parent’s business in that payments were intended to promote its own business wholly apart from that of subsidiary).

In L. Heller and Sons, Inc. v. Commissioner, 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2, the parent corporation, engaged in the business of manufacturing and dealing in jewelry, was allowed to deduct the amount paid for debts of its wholly-owned subsidiary which had undergone a bankruptcy reorganization. The payment was made to protect the parent's standing in the business community, its relationship to the jewelry trade generally, and most importantly, its credit rating. Because the payments were calculated to "protect and promote" the parent's business, the court found the payments were deductible, either as a loss or a business expense. Id.

In Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957), acq. 1964-2 C.B. 5 and acq. 1964-2 C.B. 7, a parent corporation deducted reimbursements made to a subsidiary for operating losses incurred in the manufacture of a patented fishing rod. The subsidiary was the parent's sole supplier of that particular rod. The court found the reimbursements constituted ordinary and necessary business expenses incurred by the parent in order to maintain and preserve this sole source of supply. The court allowed the deduction by the parent because the reimbursements were clearly a "business necessity." Id. at 644.

In Austin Co. v. Commissioner, 71 T.C. 955 (1979) acq. 1979-2 C.B. 1, the issue was whether a parent corporation could deduct amounts paid to its wholly-owned Mexican subsidiary to reimburse it for Mexican employment taxes incurred with respect to certain personnel. The court noted there was no doubt this relationship enhanced the successful operation of the subsidiary which benefitted the parent as its owner, but this type of "indirect and incidental" benefit was not enough to justify the parent's deduction. It concluded the payment by the parent was a "gratuity" and therefore, not deductible. Id. at 967.

In Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964), acq. 1965-2 C.B. 4, the court found that a parent corporation was not entitled to deduct one-half of the salaries and related expenses paid to certain employees of a wholly-owned subsidiary in order to induce such employees to accept work in the Philippine Islands. The court noted the parent undertook these payments "simply to aid" its wholly owned foreign subsidiary to obtain the services of needed management personnel. Id. at 815. A successful operation of the foreign subsidiary, through the services of such personnel, would obviously "inure to the benefit" of the parent corporation, and the parent's willingness to undertake this obligation is understandable. But the payments could not be construed as the parent's own business expense. Id.

Payments made by a shareholder of a corporation for the purpose of protecting his interest therein must be regarded as additional cost of his stock and such sums may not be deducted as ordinary and necessary expenses. South American Gold & Platinum Co. v. Commissioner, 8 T.C. 1297, 1301 (1947), aff'd, 168 F.2d 71 (2d Cir. 1948).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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If you have any further questions, please call the branch telephone number.

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By: ______________________________
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